

No. 14,903

In the
United States Court of Appeals
For the Ninth Circuit

THE BANK OF ARIZONA,
a Corporation,

Appellant,

vs.

NATIONAL SURETY CORPORATION,
a Corporation,

Appellee.

Appellee's Petition for Rehearing

FILED

MOORE & ROMLEY

811 First National Bank Building
Phoenix, Arizona

Attorneys for Appellee

SEP 27 1956

PAUL P. O'BRIEN, CLERK

SUBJECT INDEX

	Page
Grounds for Rehearing.....	2
Argument	3
I. At the Time Appellant Received the Contract Proceeds from the Government, It Knew That Contractor Was in Default in That He Had Failed Promptly or at All to Make Payment to the Materialmen.....	3
Subrogation	3
Assignment	5
Summary	6
II. The Assignment in the Bond Application Is Lawful and Valid as to Appellant.....	7
III. Appellant Holds the Contract Proceeds in Constructive Trust for the Benefit of Appellee.....	8
Conclusion	9

TABLE OF AUTHORITIES CITED

CASES	Pages
California Bank v. United States Fidelity & Guar. Co. (C.C.A. 9), 129 Fed. (2d) 751.....	4, 5, 6, 8
Martin v. National Surety Co., 1936, 300 U.S. 588.....	2, 7
Pacific Indemnity Co. v. Grand Ave. State Bank of Dallas (C.A. 5), 223 Fed.(2d) 513.....	8, 9
Royal Indemnity Co. v. United States, 93 F.Supp. 891.....	8

STATUTES

Assignment of Claims Act of 1940 (31 U.S.C.A. Section 203) ..	2, 5, 7
---	---------

In the

United States Court of Appeals

For the Ninth Circuit

THE BANK OF ARIZONA,
a Corporation,

Appellant,

vs.

NATIONAL SURETY CORPORATION,
a Corporation,

Appellee.

Appellee's Petition for Rehearing

*To the Honorable Homer T. Bone and Albert L. Stephens,
Judges of the United States Court of Appeals for the
Ninth Circuit, and to the Honorable Louis E. Goodman,
Judge of the United States District Court, Northern
District of California:*

Appellee respectfully petitions for a rehearing in the above cause to the end that the judgment of this Court that appellee take nothing by its amended complaint and that costs be awarded appellant, be vacated and the judgment of the lower court affirmed.

GROUND'S FOR REHEARING

Appellee respectfully urges that the opinion and judgment are erroneous and contrary to law, and that a rehearing should be granted, for three reasons:

1. The Court has incorrectly assumed that appellant had no knowledge of the contractor's default by failure to pay materialmen until after it had already received the contract proceeds from the government, and this erroneous assumption of fact formed the basis of the Court's decision. The fact thus assumed by the Court is contrary to appellant's admission and to the findings of fact made by the lower court.

2. The Court has misunderstood appellee's position in stating that "It appears to be Surety's position that while 31 U.S.C.A. § 203 precludes the assignment contained in the application for contract bond from being a lawful assignment it was nonetheless *effective as an equitable assignment*, relying upon *Martin v. National Surety Co.*, 1936, 300 U.S. 588, and is therefore valid as between Surety and parties taking later assignments with notice of the prior assignment to Surety." Opinion, page 9. Appellee contends that under the rulings of the United States Supreme Court and this Court as well, the assignment in the bond application is lawful and valid as to anyone other than the Government. It is not merely an equitable assignment; it is also a legal assignment as far as appellant is concerned.

3. The Court has failed to consider and pass upon appellee's assertion, which we earnestly contend is valid under the authorities, that appellant holds the contract proceeds as a constructive trustee for the benefit of appellee.

ARGUMENT

- I. **At the Time Appellant Received the Contract Proceeds from the Government, It Knew That Contractor Was in Default in That He Had Failed Promptly or at All to Make Payment to the Materialmen.**

The lower court awarded judgment in favor of appellee and against appellant for the sum of \$6,090.00. On this appeal, appellee contended that it was entitled to the judgment upon any one or all of three bases—subrogation, prior assignment and constructive trust.

SUBROGATION

In its opinion, this Court has concluded that after the Government paid the contract proceeds to appellant it no longer had any rights which appellee could acquire by subrogation. Underlying this conclusion is the assumption of fact (Opinion, page 2) that "Receipt of this form of acknowledgment subsequent to December 23, 1952 was the first knowledge Bank had of Contractor's *failure to pay materialmen*." This assumption is contrary to paragraph 13 of the findings made by the lower court (Tr. 45):

"13. The proceeds of the Government contract (\$12,580.00) were received by Bank from the Government on December 15, 1952. At that time the Bank knew that Contractor had not paid all materialmen, and Bank made no effort to see to it that loan proceeds were used by Contractor to pay the Materialmen or to discover that in fact Contractor had used none of the loan proceeds to pay the Materialmen."

Furthermore, paragraph IX of appellee's amended complaint (Tr. 10), which is *admitted* by paragraph IX of appellant's answer (Tr. 17), alleges as follows:

"IX.

"At the time it received the aforesaid sum of \$12,580.00 from the Government, the Bank knew, or in the

exercise of reasonable diligence should have known, that said sum represented the amount due on the aforesaid contract and that the Contractor was in default in that he had failed promptly or at all to make payment to all persons who had supplied labor and material for the prosecution of the work provided for in the contract with the Government."

The admission by appellant that it knew or "in the exercise of reasonable care and diligence should have known" that the Contractor was in default by failure to make payment to materialmen, is highly significant. At the time appellant made the loan to the Contractor and took its assignment of the contract proceeds, appellant knew that materialmen had not been paid. The stated purpose of the loan was to enable the Contractor to make such payment (Findings of Fact paragraph 10, Tr. 43; Tr. 136). At that time appellant also knew that bonds had been furnished the Government, and that if the Contractor failed to pay materialmen the Surety on those bonds would have to do so (Findings of Fact, paragraph 10, Tr. 43-44). Appellant concedes that under these circumstances "the creditor must ascertain at his peril whether or not there are any outstanding obligations of the Contractor to the laborers and materialmen before accepting payment, else he assumes the obligations of the compensated Surety to the extent of the payment received" (Brief for Appellant, page 25).

In consequence of the Contractor's default, the contract proceeds became a fund which the Government was entitled to apply in payment of the materialmen, and which appellee, as subrogee of the Government, was entitled to have applied in reimbursement of the funds expended by it in payment of the materialmen. *California Bank v. United States Fidelity & Guar. Co.*, (C.C.A. 9), 129 Fed. (2d) 751, at page 754.

And appellee's right of subrogation relates back to the date of the contract bonds. *California Bank*, at page 755. Certainly "the doctrine of relation cannot be used by a subrogee for the purpose of recovering money paid to a creditor without notice, in satisfaction of a just debt, prior to the maturing of any right of subrogation." *California Bank*, at page 755. But in this case Bank knew of the Contractor's default when it received the contract proceeds from the Government, and therefore appellant received the proceeds with "notice or knowledge that it was part of a fund in which appellee had, or might thereafter acquire, a superior right." *California Bank*, at page 755. See Brief of Appellee, pages 4-6.

ASSIGNMENT

This Court has held that appellee's rights under the assignment contained in the bond application are inferior to those of appellant under a subsequent assignment" * * * for here, as in that (*California Bank*) case, Bank took the assignment and received the proceeds before it had notice or knowledge of the failure of Contractor to pay materialmen, and had no notice of the prior assignment (not perfected under 31 U.S.C.A. § 203) to Surety." Opinion, pages 10-11.

While in this case appellant had not actual notice of appellee's assignment when appellant received the contract proceeds, "The fact that Bank knew that bonds had been furnished the Government confirms Surety in its contention that Bank was 'put on inquiry', and that had Bank inquired it would have learned of the assignment and of Surety's interest in the contract proceeds." Opinion, page 9. Nevertheless the Court concluded that appellee may not recover from appellant by any right it may have under the prior assignment because the Court again erroneously as-

sumed that "The evidence shows that it was not until Bank received Surety's response (dated December 23, 1952) to this notice of assignment that Bank had knowledge of the default in payment by Contractor to materialmen." Opinion, page 8.

The fact is, as the Court states, appellant was put on inquiry to determine appellee's rights, and had it inquired it would have learned of the assignment and appellee's interest in the contract proceeds. The fact is, as the lower court found, that when appellant received the contract proceeds it knew that the Contractor was in default in that he had failed promptly or at all to make payment to the materialmen. Appellant therefore holds the contract proceeds subject to appellee's rights under the prior assignment.

SUMMARY

We agree with the Court that its decision in this case should rest upon its holding in the *California Bank* case, supra. But the Court has incorrectly assumed the facts to be the same in both cases, when actually the reverse is true. It appears that the conclusions with regard to appellee's rights under the doctrine of subrogation and under the prior assignment were based on the Court's belief that appellant had no notice or knowledge of the Contractor's default in payment of the materialmen until after it had received the contract proceeds.

The lower court found that at the time appellant received the contract proceeds, it knew materialmen had not been paid. Appellant admitted that it knew, or should have known, of the default when it received the contract proceeds. It is therefore apparent that a mistake has been committed. When the true fact is realized, appellee is entitled to recover the contract proceeds under the principles of the *California Bank* case.

II. The Assignment in the Bond Application Is Lawful and Valid as to Appellant.

Although it may not have so intended, this Court has inferred that the assignment contained in the bond application is invalid not only as to the Government, but as to appellant as well, because it "falls within the censure of 31 U.S.C.A. § 203." Opinion, pages 8, 9, 10-11. The court has said that "It appears to be Surety's position that while 31 U.S.C.A. § 203 precludes the assignment contained in the application for contract bond from being a lawful assignment it was nonetheless effective *as an equitable assignment*, relying upon *Martin v. National Surety Co.*, 1936, 300 U.S. 588, and is therefore valid as between Surety and parties taking later assignments with notice of the prior assignment to Surety." Opinion, page 9.

The validity of the assignment in the bond application was discussed in the Brief of Appellee, pages 7-9. Appellee most certainly does not contend that the assignment is precluded from being a lawful one or that it is merely effective as an equitable assignment. The law is otherwise. The Anti-Assignment Statute (31 U.S.C.A. § 203) was enacted solely for the protection of the Government. Notwithstanding its provisions, an assignment by a contractor to his surety of the proceeds of a Government contract is a valid, legal and enforceable assignment as between the surety and a subsequent assignee of the contractor. Nor does compliance by the subsequent assignee with the Assignment of Claims Act of 1940 (31 U.S.C.A. § 203) give more validity to the subsequent assignment insofar as the surety is concerned. It merely gives the subsequent assignee a right against the Government which the surety does not have.

The foregoing principles are supported by the following cases: *Martin v. National Surety Co.*, 300 U.S. 588, 57 S.Ct.

531, 81 L.Ed. 822; *California Bank*, at page 753; *Royal Indemnity Co. v. United States*, 93 F.Supp. 891.

Appellant knew of the Contractor's default when it received the contract proceeds and appellant was put on inquiry to determine appellee's rights thereto. Had appellant inquired it would have learned of the prior assignment to appellee. Thus having constructive notice of appellee's assignment at the time it received the contract proceeds, appellant may not retain them under the above-mentioned authorities and *Pacific Indemnity Co. v. Grand Ave. State Bank of Dallas* (C.A. 5), 223 Fed.(2d) 513.

III. Appellant Holds the Contract Proceeds in Constructive Trust for the Benefit of Appellee.

The Court has failed to consider and pass upon appellee's contention (Brief of Appellee, pages 12-14) that appellant holds the contract proceeds in constructive trust for the benefit of appellee. This principle alone is sufficient to affirm the judgment of the lower court.

The significant facts, admitted by appellant, are these: when it received the contract proceeds, appellant knew that bonds had been furnished the Government, that the surety on the bonds would have to pay the materialmen if the Contractor failed to do so and that the Contractor was in default in that he had failed promptly or at all to pay the materialmen.

This Court has correctly held that appellant was put on inquiry as to appellee's rights, and had appellant inquired it would have learned of the prior assignment to appellee and appellee's interest in the contract proceeds. When appellant received the contract proceeds, it knew, or should have known, that it was receiving funds of which the Contractor was not the equitable owner. The contract proceeds

are therefore impressed with a constructive trust in favor of appellee.

This case falls squarely within the recent decision of the Fifth Circuit in *Pacific Indemnity Co. v. Grand Ave. State Bank of Dallas*, 223 Fed. (2d) 513.

The failure of the Court to consider this issue must have been through inadvertence.

CONCLUSION

The problems presented by this case were somewhat complicated and we appreciate that they were given long and careful consideration before a decision was reached. The decision made, however, is founded on a mistaken belief as to a vital fact, a misunderstanding of appellee's position, and a failure to consider a very important issue.

We strongly urge the Court to reconsider its decision in the light of the matters herein presented; and upon such reconsideration we ask that a rehearing be granted.

Respectfully submitted,

MOORE & ROMLEY

By ELIAS M. ROMLEY

JARRIL F. KAPLAN

Attorneys for Appellee

CERTIFICATE OF COUNSEL

In my judgment the foregoing Petition for Rehearing is well founded. I hereby certify that it is not interposed for delay.

Dated, September 27, 1956, Phoenix, Arizona.

JARRIL F. KAPLAN

